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# Outlook as of January 2018

## WORLD ECONOMY

- Favorable growth momentum, plus structural reforms implemented by a number of countries, should allow the current expansionary cycle to carry over into 2018.
- Capital spending by businesses, a significant contributor to US growth in 2017, should continue to expand at a healthy rate in the coming year, following the recent cut in corporate taxes. Also, despite the recent decline in the savings rate, we expect consumer spending to rise, boosted by a combination of lower tax rates and the wealth effect of higher asset prices.
- Improving consumer and business sentiment should help the European economies maintain their momentum going into the new year, although the stronger euro and pound sterling may have a slight dampening effect, as will uncertainty around the formation of a German coalition government, the ongoing Brexit saga, and the Catalonian separatist movement in Spain.
- Corporate tax reforms and continued strong global growth should drive business spending and net export growth in Japan over the next few quarters. Markets still await a pick-up in consumer spending, but this will be difficult, given the challenging demographics and high savings propensity of Japan's rapidly-aging population.
- The Chinese government may be backing off its recent pledge to reduce overcapacity and curb excessive leverage due to fears of causing an abrupt economic slowdown. A less austere policy stance in Beijing could have a beneficial impact on other countries in emerging Asia and Latin America that are heavily reliant on trade with China.

## MONETARY POLICY & CURRENCIES

- The recent ascension of Jerome Powell to Fed chair and wariness over the flattening yield curve may cause the Federal Reserve to move more slowly on rate normalization. We do not anticipate any further increases in the Fed funds rate until June.
- The Bank of England views the recent spike in inflation solely as a function of currency weakness. Uncertainty around the economic impact of Brexit should delay any further rate rises until later in the year.
- We expect the ECB to announce a definitive end to its bond purchase program in Q1, but recent currency strength will delay outright tightening of rates into 2019.
- Normalization moves by the Bank of Japan this year will likely center around relaxing the yield curve controls, and possibly scaling back purchases of equities. Any rate increases are much further out on the horizon.
- The recent tax cuts and proposed infrastructure spending program should cause a rise in the US budget deficit, helping to offset higher interest rates and tighter central bank policy and keep the dollar in a narrow trading range over the coming months.

## BOND MARKETS

- With GDP growth hovering around 3%, we expect the Fed to resume its moves towards policy normalization around mid-year. The expected reduction in Fed bond buying and rise in bond issuance to fund higher deficits should exert upward pressure on rates, both at the short end and across the yield curve. The potential emergence of inflationary pressures will control the magnitude of rate increases.
- The latest tax changes have made the tax exemption of municipal bonds even more attractive for residents of higher-tax states, which should allow municipal bonds to outperform Treasurys in the coming year.
- High yield bonds should continue to enjoy the advantage of historically low default rates, although they now appear fully valued for this stage of the economic cycle and the competitive pressures in more heavily-indebted industry sectors.
- While central bank bond buying will continue across the developed market economies, global bond yields are too low to compensate investors for the risk of any surprise tapering announcements in the coming months.
- Emerging market debt carries generous coupons in many constituent countries, which also have the policy flexibility to cut interest rates if they see signs of a slowdown. Currency is expected to be a tailwind this year for many local currency issuers.

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## EQUITY MARKETS

- With the earnings boost from tax cuts already priced in, US equities appear to be fully valued at year-end 2017. Any unanticipated rise in inflation could drive interest rates higher and cause volatility to spike above the current abnormally low levels. Without further help from multiple expansion, further stock price appreciation should correlate to earnings growth rates.
- With less immediate concern over rate hikes, lower valuation levels should allow European equities to match, or even slightly outperform, US equities in 2018.
- Having caught up in performance to other developed equity markets in the second half of 2017, Japanese equities will be more reliant on the earnings boost from higher corporate spending to drive performance in 2018, since the stronger yen and reticent consumer are likely to be headwinds over the coming months.
- Despite the strong outperformance of emerging markets equities in 2017, valuations are attractive compared to developed markets. However, questions around their continued reliance on China for growth and their ability to weather a slowdown, suggest some caution.

## ALTERNATIVES & COMMODITIES

- Crude oil, which has traded in a $40 to $60 per barrel trading range over the last three years, appears poised to break through to the upside, as supply discipline and global growth has worked off much of the excess inventory. The speed at which US shale production reacts to higher prices will determine the new ceiling, which should stay close to the current level.
- The bias towards incrementally tighter monetary policy in the US and other countries should keep gold prices from rising much above current levels, since higher interest rates increase the opportunity cost of holding gold.
- The outlook for industrial metals remains constructive, with the proposed US infrastructure spending program and higher US industrial production expected to offset any reduction in demand from China.
- Persistently low market volatility and high market correlations have challenged hedge fund managers following the global financial crisis. Moves towards policy normalization by central banks should create more favorable conditions for differentiated managers and allow investors to mitigate risks from unstable markets or policy and geopolitical uncertainty.
- High asset valuations have made it difficult for private equity managers to acquire companies at reasonable prices. We maintain our focus on seasoned, disciplined managers and continue to seek value in dislocated markets, or those experiencing disruption from technological or regulatory change.

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Ben Pace is the Chief Investment Officer and a member of the Investment Committee. Prior to joining Cerity Partners, Benjamin Pace was Chief Investment Officer and Head of Global Investment Solutions for Deutsche Bank Private Wealth Management in the U.S. Ben has more than 25 years of experience in investment management. Prior to joining Deutsche Bank in 1994, he managed equity income funds for two investment organizations.

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